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Reserve Bank of India and its Monetary Policy

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Introduction:-

Monetary policy is the process by which the monetary authority of a country controls the supply money often targeting a rate of interest for the purpose of promoting economic growth and stability. The official goals usually include relatively stable prices and low unemployment, monetary theory provides insight into how to craft optimal monetary policy:

Monetary policy is referred to as either being expansionary or a contractionary where a police expansionary police increases the total supply of money in the economy more rapidly than usual and a contractions policy expands the money supply more slowly than usual and a contractions policy expands the money supply more slowly than usual or even shrinks it expansiary policy is tats in the hope that easy credit will entice business into expanding contractionary policy is intended to slow inflation in hopes of avoiding the resulting distortions and deteriorations of asset to taxation government spending and associated borrowing.

Monetary policy rests on the relationship between the rates of interest in an economy that is the price at which money can be borrowed, and total supply of monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth inflation, exchange rate with other currencies and unemployment. Where currency is under a monopoly or issuance, or where thesis a regulated system of issuing currency through banks which are tied to a thus monetary authority has the ability to altar the money supply and thus influence the interferes rat (to archive policy goals). The beginning of monetary policy as such come from the late 19th century, where it was used to maintain the gold standard.

History of monetary policy :

Monetary policy is primarily associated with interest rate and credit. For many centuries there were only two forms of monetary policy : (i) Decisions about coinage ;; (ii) Decisions to print paper money to create credit. Interest rates, while now thought of as part of monetary authority, we are not generally coordinated with the other forms of monetary policy during this time. Monetary policy was seen as an executive decision, and was generally in the hands of authority with seignior age, or the power to coin. With the advent of larger trading networks came the ability to set the price between gold and silver, and the price of the local currency to foreign currencies. This official price know be enforced by law, even if it varied from the market price.

Paper money called "Jiaozuo" originated from promissory notes in 7 century china. Jiaozuo did not replace metallic currency, and were used alongside the copper coins. The

successive Yuan Dynasty was the first government to use paper currency as the predominant circulating medium. In the later course of the dynasty, facing massive shortages of specie to fund war and their rule in China, they began printing paper money without restrictions, resulting in hyperinflation.

With the creation of the Bank of England in 1694, which acquired the responsibility to print notes and back them with gold, the idea of monetary policy as independent of executive action began to be established. The goal of monetary policy was to maintain the value of coinage, print notes which would trade at par to specie, and prevent coins from leaving circulation. The establishment of central banks by industrializing nations was associated with the desire to maintain the nation's peg to the gold standard, to trade in a narrow band with other gold-backed currencies. To accomplish this end, central banks as part of the gold standard began setting the interest rates that they charged, both to their own borrowers, and other banks that required liquidity. The maintenance of a gold standard required almost monthly adjustments of interest rates.

During the 1870-1920 periods, the industrialized nations set up central banking systems, with one of the last being the Federal Reserve in 1913. By this point the role of central banks as the "lender of last resort" was also increasingly understood that interest rates had an effect on the entire economy, in no small part because of the 'marginal revolution in economics, which demonstrated how people would change decisions based on change in the economic trade-offs.

Trends in central banking :

The central bank interest rates by expanding or contracting the monetary base, which consists of currency in circulation and bank reserves on deposit at central bank. The primary way that the central bank can affect the monetary base is by open market operations or sale and purchases of second hand government debt, or by changing the reserve requirements. If the central bank wishes to lower currency in circulation or creating banks' reserve account. Alternatively, it can lower the interest rate on discounts or overdrafts (loans to banks secured by suitable collateral, specified by the central bank). If the interest rate on such transactions is sufficiently low, commercial banks can borrow from the central bank to meet reserve requirements and use the additional liquidity to expand their balance sheets, increasing the credit available to economy. Lowering reserve requirements has a similar effect, freeing up funds for banks to increase loans or buy other profitable assets.

A central bank can only operate a truly independent monetary policy when the exchange rate is floating. If the exchange rate is pegged or managed in any way, the central bank will have to purchase or sell foreign exchange, these transactions in foreign exchange, these transactions in foreign exchange will have an effect on monetary base analogous to open market purchases and sales of government securities; if the central bank buys foreign exchange, the monetary base expands, & vice versa. But even in the case of a pure floating exchange rate, central banks and monetary authorities can the best agreement of the exchange rate will influence domestic monetary conditions. To maintain its monetary policy target the central

bank will have to sterilize or offset its foreign exchange operations. For example, if a central bank buys foreign exchange (to counteract appreciation of the exchange rate), base money will increase. Therefore, to sterilize that increase, the central bank must also sell government debts to contract to monetary base by an equal amount. It follows that turbulent activity in foreign exchange markets can cause a central bank to lose control of domestic monetary policy when it is also managing the exchange rate.

Type of monetary policy :

In practice, to implement any type of monetary policy the main tool used is modifying the amount of base money in circulation, the monetary authority does this by buying or selling financial assets (usually government obligations). These open market operations change either the amount of money or its liquidity (if less liquid forms of money are bought or sold). The multiplier effect of fractional reserve banking amplifies the effects of these actions.

Inflation targeting:

Under this policy approach the target is to keep inflation, under a particular definition such as Consumer Price Index, within a desired range.

The inflation target is achieved through periodic adjustments to the Central Bank interest rate target. The interest rate used is generally the interbank rate at which banks lend to each other overnight for each flow purpose. Depending on the country this particular interest rate might be called the cash rate or something similar.

Price level targeting :

Price level targeting is similar to inflation targeting except that CPI growth in one year over or under the long term price level target is offset in subsequently years such that a targeted price level is reached over time e.g. five years, giving more certainty about future price increases to consumers. Under inflation targeting what happened in the immediate past years is not taken into account or adjusted for in the current and future years.

Monetary aggregates :

In the 1980s, several countries used an approach based on a constant growth in the money supply. This approach was refined to include different classes of money and credit (M0, M1 etc.) in the USA this approach to monetary policy was discontinued with the selection of Alan Greenspan as Fed Chairman.

Under a fixed system of fixed rates, the local government or monetary authority sets a fixed exchange rate but does not actively buy or sell currency to maintain the rate. Instead, the rate is endorsed by non-convertibility measures (e.g. capital controls, import/export restrictions, etc.) In this case there is a black market exchange rate where the currency trades at its market/unofficial rate.

Fixed exchange rate :

This policy is based on maintaining a fixed exchange rate with a foreign currency. There are varying degrees of fixed exchange rates, which can be ranked in relation to how rigid the fixed exchange rates, which can be ranked in relation to how rigid the fixed exchange rate list with the anchor nation.

Under a system of fixed rates, the local government or monetary authority declares; fixed exchange rate but does not actively buy or sell currency to maintain the rate. Instead, the rate is enforced by non-convertibility measures (e.g. capital controls, import/export licenses, etc.) In this case there is a black market exchange rate where the current trade its market/unofficial rate.

The gold standard is a system under which the price of the national currencies measured in unit of gold bars and is kept constant by the governments promise to buy or sell gold at a fixed price in terms of the base of "fixed exchange rate"

The minimal gold standard would be a long-term commitment to tighten monetary policy enough to prevent price of gold from permanently rising above parity. A full gold standard would be a commitment to sell unlimited amounts of gold at parity and maintain a reserve of gold sufficient to read the entire monetary base.

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